

PN-444-632

53094

LIMITED OFFICIAL USE

Country Development Strategy Statement

FY 1985



Panama

January 1983

Agency for International Development
Washington, D.C. 20523

LIMITED OFFICIAL USE

THIS STRATEGY STATEMENT HAS BEEN PREPARED BY THE
A.I.D. FIELD MISSION. IT IS PREPARED ANNUALLY AND
USED FOR PLANNING PURPOSES IN THE FIELD AND IN
WASHINGTON. IT DOES NOT REPRESENT OFFICIAL AGENCY
POLICY!

**

*

LIMITED OFFICIAL USE

U S A I D / P A N A M A

FY 1985 CDSS UPDATE

February 1983

LIMITED OFFICIAL USE

P A N A M A

FY 1985 Country Development Strategy Statement Update

Table of Contents

	<u>Page</u>
1. Introduction	1
2. Summary of Development Problems Confronting Panama	1
A. Status of Panama's Development	1
B. Growth Prospects	6
3. Economic Update	8
4. Unemployment Now and Prospects for the Future	14
5. USAID Strategy Update	16
A. Introduction	16
B. Strategy	19
(1) Employment	21
(a) Policy Formulation	22
(b) Export Development	24
(c) Productivity Improvement	26
(d) Small Business Development	27
(e) Private Sector Organizations	28
(2) Agriculture	31
(a) Policy Formulation	32
(b) Technology Development and Dissemination	33
(c) Food Processing and Agro-Industry	34
(d) Natural Resources	35
(3) Urban Development	36
(a) Policy Formulation	36
(b) Shelter Production	38
(4) Other Activities	39
6. Policy Dialogue in Panama	41
7. Private Sector	51
8. Other Donors	54
9. Assistance Levels	58
A. Resources	58
B. Staffing	61

11

1. INTRODUCTION

This CDSS Update is both an update and a further elaboration of the strategy contained in the FY 84 CDSS. The development problems facing Panama remain the same and are summarized herein as background. The Update covers the main events taking place since the CDSS was written, namely the economic slump and the change of Government last July. It further provides the current situation of each of the elements under the strategy, showing how each one has evolved from last year. The strategy is further elaborated and refined in the three sections dealing with policy dialogue, the private sector and other donors. Finally, the assistance levels needed to support the strategy are presented. These essentially remain the same as last year but the Mission's efforts to upgrade and retool its staff to carry out the strategy are outlined.

2. SUMMARY OF DEVELOPMENT PROBLEMS CONFRONTING PANAMA^{1/}

A. Status of Panama's Development

Panama has been engaged since 1970 in a major development effort--perhaps the most successful in Latin America--to expand basic social services to its rural and urban poor. Low-cost paramedic health services were introduced and expanded throughout the country, potable water and sanitation were extended to rural villages and squatter barrios, family planning services were increased significantly, primary schools were built throughout the nation and rural electrification was introduced into large sections of the country.

^{1/} The analytical underpinnings of the statements made in the following section are to be found in the FY 84 CDSS.

The World Bank, in reviewing the effort of the last years, reported that ".....the greatest success (of this Government) has been in the provision of basic services to its rural citizens at the same time it expanded coverage and improved the quality of services in urban areas".

The Revolutionary Government which came into power in 1968 correctly believed that the Canal, import-substitution opportunities in manufacturing and banana output would no longer provide the stimuli necessary to keep the economy growing at its historical 6-8% rates. It was convinced that Panama's comparative advantage lay in off-shore banking, regional conventions, international commerce and other export-oriented service industries. The Government spent considerable sums to provide the public infrastructure to support such activities. The Government's goal was to generate sufficient revenues from these urban-based activities to finance its social investment in rural Panama and thus to reduce poverty, expand output and integrate the urban and rural economies more closely.

Although the social achievements have been solid, they tend to obscure a significant economic failure--Panama has been unable to maintain adequate across-the-board economic growth on a sustained basis. Growth of the Panamanian economy throughout the 1970s and early 1980s has been erratic. In the decade of the 1960s the economy grew at an average rate of 7% per annum. Panama entered a recession in 1974 that lasted through 1977, with economic growth averaging about 1.8% per annum. Subsequently, growth recovered to about 7% in 1979 and since then has fallen steadily to near zero in 1982. The policies which have guided the economic strategy pursued by the Revolutionary

Government have had the effect of favoring the financial and free zone sectors and producing unbalanced growth. The rapid growth of these two sectors has led to large real increases in the salaries of the best paid groups in the economy, representing a mere 3-4% of total employment, and has spawned the growth of high-class commercial establishments, high real estate values, and specialized professional services--the creation of practically a separate wealthy economy within the overall Panamanian economy. Moreover, expansion of these two sectors induced little demand in the manufacturing and agriculture sectors.

During the same period profitability in agriculture, livestock and manufacturing (including agroindustry) fell. At the end of the 1960s, profitability for the three sectors was slightly greater than 20%, with inflation rates of about 5%. By the end of the 1970s, however, profitability was less than 10% and inflation was on the order of 14%, producing a negative real profit. The emphasis on social equity and not economic viability and the establishment of price policies based on a goal of self-sufficiency in the production of vital crops led to inefficient state-run cooperative farms (asentamientos) and to state agroindustrial enterprises. These factors also led to the misallocation of land, low yields, high cost farm practices, and a sector dependent on other sectors of the economy to subsidize its inefficiencies.

Given recent changes in international conditions the Panamanian economy is unlikely to achieve even the limited growth of the 1970s. Expansion of the commercial and financial sectors appears to have played out.

The slow recovery of world trade will mean slow recovery of Panama's shipping and commercial services. There is little dynamism to be expected from these already highly developed sectors. The traditional markets of the Colon Free Zone have dried up with little prospect for improvement in the near term. The violence and economic crisis in Central America and the foreign exchange crisis faced by the Free Zone's major South American clients have sharply curtailed Free Zone sales, reportedly by some 40%. The outlook for tourism is not hopeful because of concerns with violence in Central America.

The Government now finds itself confronted with several important but divergent problems that must be solved in order to obtain enough economic growth to overcome the failures of the past, maintain the social gains and achieve its ambitious development objectives. First, the agricultural sector must be revitalized. While this sector will not play a key growth role in the near future, its drain on the economy must be lessened. This will require price, export and import policy changes and changes in the welfare attitude that has characterized GOP thinking toward the sector.

Second, the private sector's distrust of the Government, which had its origins in the class politics that brought the Revolutionary Government into power and which was reinforced by Government actions in the early 1970s, must be overcome. While there has been noticeable improvement in government/private sector relations, particularly in recent months, changes are still needed if the private sector is to regain the confidence required to undertake major investment programs needed to revitalize the economy.

Third, the labor force is growing and will continue to grow at a rate over the next several years which would require an economic real growth rate in excess of 8% in order to keep the unemployment rate below 10%.

Unemployment is now the most serious economic problem the country faces. The Mission estimates that the national unemployment rate is approaching 20%, with unemployment in the Metropolitan Area just over 20% and with large pockets such as in Colon well in excess of 20%.

Closely related to the employment problem is another problem which Panama continues to face--its rural-to-urban transformation. In 1970, the country was half urban, with 44% of the population living in the Metropolitan area (Panama, Colon and suburbs). By 1980, the figures were 57% urban and 49% Metropolitan area, and by the year 2000 the Metropolitan area alone is projected to hold more than 60% of the population. The consequences of Panama's rapid transformation from a rural to an urban society has had a direct and visible impact on the Canal area. Although extensive public investment has maintained water, sewerage, education, health and other public services at adequate levels, urban development has not kept pace with demand. The problems associated with this rapid growth call for not only new employment opportunities, but also the provision of shelter, services and facilities for the burgeoning population.

Finally, the Government must overcome a serious public debt problem which has its origins in the mid 1970s when, to the unprecedented volume of concessionary loans obtained in to finance social projects, the GOP added expensive commercial loans in an attempt to offset the natural fall in private

investment resulting from the 1974-77 recession. With the severe debt problems bedeviling both Panama and the large Latin American countries, commercial loans are becoming more difficult to obtain and, as a consequence, the country finds itself unable to use foreign debt, as it attempted to do in the mid 1970s, to spur economic growth. With total public debt for several years running at 90% of GDP, the Government has been forced to curtail expenditures and adopt austerity budgets. The result has been the reduction in new social programs over the last several years, and hence a reduction in the amount of services available on a per capita basis.

B. Growth Prospects

If the Government can successfully provide the incentives needed to renew private investment in manufacturing, exercise improved control over its own finances, and adopt more balanced policies affecting the agricultural sector, there is an excellent chance that the country will be able to develop a healthier economy with adequate distribution of the gains and providing sufficient employment opportunities. Supporting this positive view of the future was the elevation in July 1982 of the private sector-oriented Vice President to the Presidency, his appointment of several of like-minded technocrats to important government positions, and the pro-private sector stance of the new commander of the National Guard. A manifestation of this change was the creation, soon after the President took office, of the Investment Council of Panama, where private and government sector representatives are working together to promote new export-oriented industries

in Panama. Changes in policy which were unthinkable a few years ago are now being widely discussed and actively considered. These actions are evidence that the Government believes the private sector is key to the future economic growth of the country and they have lessened of the distrust which has existed between the private and public sectors since the early 1970s.

Complicating and threatening the move toward a more rational set of economic policies and objectives is the Presidential election looming on the horizon in 1984. Short-run politics may subvert the good intentions of the technocrats. Yet, even when this important political variable is added to the developmental equation, there remains the feeling that there are forces now working in the political arena which at least will begin the process of developing an economic structure that will be able to lift the economy out of the doldrums once the elections are over and once the world economy begins to recover.

The key to more rapid growth and higher employment in an economy as small as Panama's is the development of a strong export program covering as wide a range of products as possible, with concentration on the three neglected sectors of agriculture, livestock, and manufacturing (including agroindustry), which provided the 6-8% annual growth rates during the 1950s and 1960s, and on a program which emphasizes increased services to the Canal traffic.

More balanced growth hinges on three key factors:

(1) the successful change in policies which have been hampering the several sectors discussed earlier; (2) Panama's ability to attract new investment; and

(3) the ability of the agricultural sector to raise profitability. The pivotal element is policy change. Until the private sector receives these positive policy signals, the other two factors will have little chance of success.

Thus, to the extent the country can adopt more appropriate policies, can promote private investment, can manage its expenditures better, can raise agricultural productivity and production, and export some of this increased industrial and agricultural production, Panama will have a chance to obtain the rates of growth necessary to raise employment to satisfactory levels and continue the highly successful social programs initiated in the 1970s.

3. ECONOMIC UPDATE

Economists from both the public and private sectors have estimated that the economy grew at about 1% in real terms during 1982. However, few will be surprised if the final national accounts statistics for 1982 reveal that the economy did not grow at all during the year. Such a performance represents the third successive year in which the economy has decelerated and provides further evidence that import substitution, the Canal, and the financial and free zone sectors no longer provide the dynamism the economy needs to sustain growth.

In nominal terms, manufacturing output grew at 4 % during the first half of 1982. With inflation at about 7% during the period, there was a decline in real terms of about 3%. Data on credit extended by the banking system to local industrial enterprises confirms this trend. Statistics available on

employment in manufacturing industries in Panama City and Colon indicate virtually no growth in the number of employees or wages paid during the past year.

Private construction activity has leveled-off after a boom in the past few years. Nevertheless, some economists estimate that as a result of existing projects, the construction sector may have increased by as much as 8% in real terms during the year. As current projects are completed, however, the sector may begin to experience a rapid decline unless tax incentives to the sector, now under discussion, come on stream.

The foreign trade current accounts balance worsened in the first half of 1982 as total exports fell 17.5% while imports increased by 5.9% as compared with 1981. Among those exports suffering declines were bananas, sugar, coffee, fishmeal, and milk products. The first three have been major exports over the last two decades and now show signs of permanent decline. Those products registering gains were shrimp, clothing, meat, leather, paper products, and canned crab meat.

Recession, debt problems, and currency devaluations among the traditional Latin American customers of the Colon Free Zone (CFZ), according to many CFZ businesspersons, have led to a 40% drop in trade volume in the CFZ (imports plus re-exports). The Ministry of Planning estimates that this drop in value has led to an 11% drop in the value of Panamanian services exported to the Zone. In the second half of 1982 three of the largest CFZ exporters laid-off 400 employees. Further employment reductions in the CFZ seem likely in 1983. A tourist trade highly dependent on the Latin American tourist has suffered the

the same fate as the Colon Free Zone. Available figures show a 5% decrease in the number of tourists in the first nine months of 1982 compared with 1981.

Partially offsetting the above negative impacts on GDP was an 18.3% increase in income flowing into Panama from expenditures of U.S. Government agencies involved in Canal operations in the first nine months of 1982 compared with the first nine months of 1981. The largest area of increase was in payments to contractors and Panamanians on the U.S. payroll. Treaty payments continued to increase with a gradual rise in Canal traffic, although the world recession began to lead to lower ship traffic in late 1982 and should lead to lower treaty payments in 1983. In addition, the diversion of the oil shipments to the new oil pipeline across western Panama will further lower Canal payments. In this case, however, pipeline fees charged to transport the oil through the pipeline will offset the toll losses to the Canal so that there will be no loss to the economy as a result of the shift. In fact, the activities centered around the pipeline should lead to a slight increase in national income.

For the first time in two years, the total amount of local credit outstanding fell in the second quarter of 1982. The main component responsible for the decline was public sector borrowing. Commercial credit, the largest component, nevertheless continued to experience moderate growth after a slight decline in the last quarter of 1981. Agricultural credit outstanding continued its moderate growth as new loans extended to the sector grew throughout the first half of 1982. In fact, agricultural credit showed greater growth than that in any other sector. Its impact on agricultural

production, however, was minimal; per capita agricultural production continues to decline, especially that of staple crops. The reasons are the same as in the past--inadequate pricing policies and lack of agricultural extension services and improved technology. Nevertheless, there are some signs of improvement, especially in cattle, where beef prices and liberalized export regulations have provided an incentive to production.

1982 and 1983 Budget Crisis

As a result of sound financial management since 1979, Panama was able, in 1980 and 1981, to stay well within the debt guidelines negotiated with the IMF. 1982 was expected to bring more of the same. Unfortunately, by year's end the GOP had incurred a total deficit of \$450 million, almost double the amount agreed to with the IMF in late 1981. This heavy flow of red ink was a result of unanticipated central government revenue shortfalls due to the recession and excess expenditures in several decentralized agencies. Total public debt once again rose to about 90% of GDP.

To redress the debt problem created by the large 1982 public deficit, the GOP has set its 1983 investment budget at \$115 million less than actual expenditures in 1982, while raising its operating budget by only \$87 million from the 1982 level to cover essential items such as increases in salaries and debt servicing. In nominal terms the 1983 budget will be about \$28 million less than 1982 GOP expenditures--a 6% drop in real terms. It appears that for 1983 the IMF would like the GOP to confine its borrowings to international concessionary loan sources, to a new World Bank structural adjustment loan,

and to larger than normal IMF financing. Even if the current fiscal crisis is overcome, the large existing public sector debt and the impact upon the international banking sector of the recent debt problems incurred by Mexico, Venezuela, Brazil, and Argentina will prevent the GOP from contracting in the foreseeable future new commercial debt at the levels it has in the past.

Growth Prospects for 1983 and beyond

"More of the same" should characterize the state of the economy in 1983 and at least into the first half of 1984. During a period when domestic consumption and private sector investment are not expected to increase substantially, a real fall in Government expenditures of \$133 million in 1983 could well be recessionary. There is little expectation that sugar, bananas, tourism, or Canal revenues will increase. In fact, a revenue decline from these sources is more likely. Exports of the industrial manufacturing sector and the Free Zone will continue to suffer unless the principal markets in Central and South America begin to turn around.

On the positive side, there are indications that meat sales to Venezuela and the United States will increase in response to the GOP's efforts to exploit the country's comparative advantage of its meat industry. Shrimp exports should continue expanding and two promising clothing markets could pick up the slack in the industrial manufacturing sector. Domestically, the one bright possibility lies with the construction industry. It will require the passage of a new tax incentive (which is in the works) for the middle class rental apartment market. As noted earlier, if it does not occur soon,

construction could begin to tail-off in the second half of 1983.

By 1985 there should be a significant upturn in the economies of many of the developed countries, especially the U.S. This should translate into an increase in world trade and consequently into some growth for Panama as the unit value and amount of exports increase, however slightly. By then, domestic businesses should be in the process of increasing production in order to replenish depleted inventories and new investments should be occurring as a result of the work of the newly created Investment Council of Panama, passage of the trade components of the Administration's Caribbean Basin Initiative and from an improving world economy.

Finally, a reduced price of oil, reduced interest rates, increased international liquidity (partially a result of the February IMF meetings leading to a larger lender's fund), and the shedding of several unprofitable state enterprises may significantly reduce the drain on the Government treasury over the next few years. If this occurs, the difficulty in obtaining commercial borrowings may no longer be a constraint to stimulating economic growth; the GOP may find that it has sufficient savings of its own to finance the bulk of the projects necessary to stimulate the economy. Commercial borrowings, if needed, would be used to top off the financing of government projects. Whatever occurs, it is clear that the practice of depending on large commercial borrowings to finance a large portion of the investment budget is at an end.

4. UNEMPLOYMENT NOW AND PROSPECTS FOR THE FUTURE

In its of June 1982 report, "Panama, Special Economic Report: Metropolitan Unemployment," the World Bank formally recognizes, as the USAID did several years ago, that GOP official statistics have understated the unemployment problem and that by 1985 unemployment could reach 25%. Assuming that the economically active participation rate is 60% among those in the 15-64 year range and that for every 1% increase in real GDP 0.42% more jobs are created, we estimate that in 1982 nationwide unemployment was approximately 20% and that in the Panama City-Colon metropolitan area it reached 22%. At these rates, approximately 148,000 people are estimated to have been unemployed nationwide at the end of 1982, an increase of 56,000 since 1979. With approximately 20,000 new job seekers annually, this implies that during the most recent five year period the economy, on an average, produced slightly more than 9,000 jobs each year. Using the same procedures and figures, but assuming that only 56.89% of the working age population is actively seeking work (compared to our 60% figure), the World Bank estimates Metropolitan unemployment at 18% for 1982. Though the Bank did not go on to estimate nationwide unemployment, its procedures would yield a 15% figure.

Regardless of which of these two sets of calculations one uses, the numbers are unacceptably large and will continue to increase unless annual real economic growth exceeds 8% or returns to its historical 6%-8% levels and the economic structure becomes more labor intensive. Our earlier predictions (USAID/Panama "Employment Strategy", June 1981) of 25% unemployment by the mid-1980s is likely to occur given that the economy has not approached the

6%-8% rate since 1979 and that it is not expected to do so for some time.

Slightly over 50% of the unemployed are in the 15-24 age bracket. Presumably this group is fairly new to the job market and can be assisted by the family until a job is found. While this phenomenon may explain why there has been an obvious lack of social unrest during a time when the unemployment rate has been estimated to be hovering near 20%, there is increasing concern that a stagnant economy, or one growing over the next few years at only 1-3% annually, will eventually produce social unrest as the extended family help begins to break down due to lowered real per capita income and depleted savings. The 1983-88 period is probably the critical time which will determine Panama's future as a nation either on its peaceful way to becoming a developed country or one struggling with the social problems created by an unemployment rate in excess of 25%. On the bright side, by 1990 the number of new workers coming on to the job market should begin to fall. Lower economic growth rates then will begin to satisfy labor needs and reduce the overall unemployment pressure. The difficulty will be getting to 1990 without the unemployment problem becoming politically explosive.

Another element which will play a key role over the next few years is that of underemployment, defined to include those who, while employed, make less than what would be considered a subsistence wage, either because they are able to find only part-time work or because their wages for full-time work are too low to meet basic needs. Underemployment is a particularly critical problem in the agricultural sector where people cannot afford to be unemployed. A 1974 ILO/PREALC study estimated that 30-50% of the national workforce and

20-30% of the metropolitan workforce were underemployed. A 1981 nutritional study corroborates the earlier ILO/PREALC findings. Using the relationship between a household's income and the cost of a minimum basket of goods, the study concludes that 23% of urban households and 54% of rural households suffer extreme poverty, i.e., cash and imputed income is less than the value of a minimum basket of goods. Although real per capita income has been slowly increasing, there are indications that a significant number of people have not shared in the increased income. Real minimum wages have declined sharply over the past several years. With economic growth rates expected to remain low and near the population growth rate for a number of years, there will be increasing pressure on real incomes for those income groups which can ill afford the reductions.

In summary, there is mounting evidence to support a prediction that unemployment as well as underemployment are going to get worse and not better and that this will create a difficult social and economic problem for Panama during the 1985-89 period.

5. USAID STRATEGY UPDATE

A. Introduction

As pointed out in the last CDSS, Panama is going through a transition period. The 1977 Canal Treaties increased Panama's role in the operation and

maintenance of the Canal and, by the year 2000, Panama will assume full control over Canal operations. During this transition period, implementation of the Treaties will likely continue as a source of friction between the U.S. and Panama as both countries attempt to interpret treaty provisions across cultural barriers and differing perceptions of national interests. Extraordinary effort will be needed on both sides to not permit this friction to affect the transition process or to spill over onto other aspects of our bilateral relations.

Panama also faces a difficult political transition from a military to a democratically elected, representative government in 1984. Elections will be held in mid 1984 for the Presidency and the National Assembly. These will be the first free general elections held in 16 years and are the final stage of a carefully orchestrated process initiated by the late General Omar Torrijos to return the country to civilian rule. At the moment opposition parties are organizing, an electoral census has been held, reforms are in study for amending the Constitution and the general decibel level is going up. There is strong concern by the opposition that the National Guard will not in fact relinquish power. The Guard, on the other hand, sees a fragmented opposition making irresponsible charges and wonders publicly if the politicians will in fact be able to run the country. Widespread unhappiness with a worsening economic situation and with the government's attempt to manage it and the growing possibility of political unrest led the National Guard to oust President Royo last July and replace him with Vice President Ricardo de la Espriella. The final complication in the process is the fact

that the present head of the National Guard is an acknowledged favored candidate for the presidency.

Panama's development strategy is also in transition. The country seems to have come to the end of a 14-year development effort which in many respects was highly successful but has played out. While the strategy as a whole has been successful, particularly the effort to reach the masses (and AID can be proud of the role it played in assisting that effort), the country has not gotten the sustained economic growth required to support the existing social effort over the long run. The country has the highest per capita debt in the region and the need to regain control of its financial situation is forcing austerity budgets, with consequent reduction in public services and with a potential recessionary impact on the economy which can only exacerbate an already difficult unemployment problem.

The roles of the private and public sectors are also in transition. After taking power in 1968, the Revolutionary Government was openly hostile to the private sector, significantly expanding the government's role and curtailing the private sector, primarily through a new labor code, price controls and a housing law. The market system was to be directed, and even replaced when necessary, by the state in order to assure equity. However, the failure of state enterprises, widespread corruption, an almost untenable public debt and growing unemployment have forced the Government to rethink the role of the private sector and the value of a market system. The change of Government last July, with the appointment of a pro-private sector banker to the Presidency, was a clear and positive signal that public private sector

relationship are changing. However, there is some fear, particularly among the middle and lower classes that the gains made in the last 14 years in the name of social justice may be lost in the process. The tension between the advocates of a free market system and those who benefitted most from Torrijos' social revolution dominates the political landscape.

The outcome of the evolution underway in Panama has important regional implications. One of the aspects of the region-wide turmoil bordering Panama involves a struggle over the proper role of the private and public sectors and the relative merits of a free market economy. The private sector is under attack throughout the region, linked by its detractors to economic and political systems that operate at the expense of the many for the benefit of the few. Despite the pressures against the private sector during the early years of the Revolutionary Government, Panama has had a strong private sector with some of the most progressive entrepreneurs in the region. It is important to demonstrate to Central America, particularly at this time, that a market economy can meet the aspirations of all members of society, not just a few. In addition, the private sector in Panama provides a moderating influence on those private sectors under siege throughout the region that may otherwise be tempted to seek authoritarian, repressive solutions to the current turmoil.

B. Strategy

The USAID strategy supports the rethinking and reorientation of the Government's development strategy to accelerate growth and job creation. It

does so by focusing on the major problems creating obstacles to Panama's future development in the areas of employment, agriculture and urban development. Because a successful resolution of the first two requires increased growth and productivity, it will be necessary for the country to pursue a different growth strategy than in the past. The Government's fiscal problems and lack of a monetary policy prevent it from directly stimulating the economy to any significant degree. For this reason the private sector must play the critical role in any such growth strategy and therefore must have a larger role in the economy. The focus on growth and productivity is not an abandonment of the social goals that brought the Revolutionary Government to power in 1968. The underlying assumption is that the mechanisms and systems which permitted the expansion of social services are solidly in place and could not be abandoned even if a future government so desired. Therefore, outside assistance is no longer required, to the extent it is in other countries, to focus the Panamanian government's attention on these problems.

The AID strategy continues a third thrust, urban development, because of the impact of the rural/urban transformation underway, the volatility of this migration adjacent to the Canal, and the importance of home ownership as an integrating and stabilizing influence.

The strategy will be implemented through a combination of policy formation and institution building. The formulation of a development strategy and appropriate policies in all three problem areas is a function of policy dialogue. The approach to policy dialogue in Panama is substantially

different to that found in other AID programs with more substantial resources. In Panama the approach is evolutionary and involves intensive interaction and consensus building. This approach is more fully described under Section 6, "Policy Dialogue in Panama." Institution building is simply another name for developing the mechanisms, systems, and programs to carry out the elements of the strategy. Since the AID program in Panama is not a resource transfer program, all Mission projects in Panama can be expected to have significant institution building elements.

(1) Employment^{1/}

The goal of the AID employment program in Panama is to increase employment opportunities by assisting both the Government and the private sector to develop and implement a continuous program marshalling public and private resources. Such a program implies accelerated growth rates spurred by higher investment levels and also a change in the historical pattern of growth toward more labor intensive activities. The employment program is premised on the assumption that the basis for future growth and job generation of the Panamanian economy lies in exports, particularly light assembly industries, industrial shipping (ship repairs, etc.) and agroindustry. Export industry will induce investment and job creation in other sectors through multiplier effects. Small business will be a second key element of the employment

^{1/} The following sections are updates of the FY 84 CDSS. See that document for additional background material.

strategy because there appears to be significant room for expansion of this subsector, with its lower investment cost per job, if key support services are made available. In addition, the importance of this subsector as a support base for developing entrepreneurial and pro-private sector attitudes cannot be overestimated.

The basis for USAID's employment strategy is the emergence of two important shifts in government policy: 1) recognition and support of private enterprise as the major contributor to economic growth in contrast to previous reliance on public programs; and 2) recognition of export industry as the growth leader that must take over from the services sector and import substitution.

The objectives of the Mission program to accomplish the employment goal are to: (a) strengthen the government's ability to analyze employment problems and devise policies and programs that will increase investment which maximizes employment; (b) establish and strengthen those institutions, industries and programs which promote labor intensive activities consistent with acceptable levels of efficiency; and (c) increase the productivity of labor and capital through institutions skills and related training and technical services for workers and management.

(a) Policy Formulation

The Policy Analysis and Research System (PARS) developed under the FY 81 Employment Planning and Generation Project continues to be a major initiative in this area. It is designed to provide the analytical basis

for policy dialogue between the Government and private sector. The PARS appears to finally be underway after several false starts. The office has been organized and established. A study on industrial incentives is underway and a second study on port authority practices affecting exporters is being developed. However, additional Institutional development work is still needed.

A second major player has come on the scene--the newly created Investment Council of Panama (ICP)--with a major policy-making role through both its board of directors and its staff. An AID advisor will be developing the linkage between the PARS and the ICP so that the PARS provides additional analytical capacity for the ICP as well.

Additional dialogue with the Ministry of Labor and private sector associations regarding the policy implications of skills training, productivity and the labor code is increasing public and private sector understanding of existing impediments to increased investment. Continued discussion and interchange is expected to focus GOP and private sector attention on restrictive policy elements and provide options for consideration, leading to more coordinated efforts in policy reform.

We are proposing to open up a major new area of policy analysis and formulation. It has become evident in dealing with the two Planning Ministers of the successive governments over the last year that there is no overall strategy for accelerating growth and addressing the growing employment problem. Consequently, the movement taking place within the Government toward export-led growth is bypassing that Ministry. The export strategy has to be placed into some overall concept. In addition, we are

finding that our agricultural policy dialogue has no overall context. In discussing price policy with Agricultural and Planning officials, the role of agriculture in the economy and resources required in the sector become crucial. However, there is no overall framework in which to discuss policy changes.

USAID has discussed with the Ministry of Planning and the Ministry of the Presidency the desirability of establishing a capacity in the the former to analyze and develop strategic policy alternatives at the national and sectoral levels. In addition, the need for such a planning effort was discussed with the head of the National Guard. All have expressed strong support for the idea. We are now beginning exploratory discussions with the planning bureaucracy. If successful, we will expand these talks into a major technical assistance effort to help the government develop its strategic planning capacity. We would expect a requirement for \$500,000 a year starting in FY 84.

(b) Export Development

One of our major thrusts continues to be in the export promotion area in support of the Caribbean Basin Initiative, and our thinking has evolved as we have expanded our contacts and thought through our CBI strategy. The export promotion approach is primarily market oriented. This is a radical departure from the product oriented efforts which characterized past Panamanian efforts. The shift assumes that expanded export production will not result from attempts to sell the products of the high cost, tariff

protected industries which presently make up much of Panama's industrial community. Instead it will require the formation of new or modification of old production facilities designed so as to function efficiently for competition in world markets. In the short run, only foreign firms with already established markets, effective management and appropriate technology are likely to be capable of establishing the necessary types of production facilities. In the medium and longer term, domestic investors may participate, in most instances through joint-ventures with foreign firms and increasingly through whole domestically-owned firms.

Since the last CDSS, the Investment Council of Panama (ICP) has come into existence, designed to induce foreign and domestic investment in export production. The Council has been internally organized to reflect three functions: policy and research, investment promotion and "one stop" investor services. We will assist the ICP through loan and grant funded technical assistance to permit it to aggressively pursue its mandate. Early operations of the ICP have resulted in the attraction of foreign investors, supporting the assumption of Panama's comparative advantage which underlies the ICP program.

The market information generated by ICP operations will permit the revival of an export promotion effort probably within the Ministry of Commerce. The responsible organization will be strengthened and its role more precisely defined as an agent for facilitating exports from local manufacturers and for inducing domestic investment in export oriented activities. Other requirements for increasing exports are the availability of

longer term venture capital and export financing, and USAID may provide assistance in these areas.

To facilitate private sector access to markets and resources through its own mechanisms, the USAID is exploring the possibility of assisting in the creation of a leasing corporation and a trading corporation. These activities may involve both technical and financial assistance.

(c) Productivity Improvement

The deficiencies in training responses to Panamanian skill requirements noted in the FY 84 CDSS continue to be a serious impediment to the attainment of industrial and commercial potentials. To foster utilization of Panama's human resources and to ease under and unemployment conditions, a portion of AID resources will continue to be directed at employment planning, skills training and the removal of impediments to improved productivity. In designing the Workforce Development project the Mission will be exploring, with the assistance of private sector associations and labor organizations, several innovative approaches to meeting Panama's labor force needs. If these groups are successful in urging GOP officials to adopt these changes, a breakthrough of significant proportions will occur.

After a slow start, the Management Information System segment of the Employment Planning and Generation Project has reached its implementation phase within the Ministry of Labor. This phase provides support to the development of an informational base on labor supply and

unemployment and will give guidance to training organizations and to economic and business planners, on both macro and micro levels.

One of the principal users of manpower information will be INAFORP, the about-to-be-created central training agency, which will incorporate the training needs of the private sector in its programs. USAID is currently preparing a project to support Panama's skills training needs that can be coupled with existing and future job requirements. As presently conceptualized, the project will depart from previous fixed facility and curriculum practices to a more flexible, non-institutionalized response to the needs of the private sector. In-plant training through training contractors and plant management, with costs shared by client companies and INAFORP, will more effectively respond to identified needs, at lower costs and without maintaining a large permanent staff.

While manpower utilization is a major element in improving productivity, management and technology have equally important roles. The USAID will explore the possibilities for a program which will contribute to productivity improvement through information services, technical assistance and organizational development.

(d) Small Business Development

While the main focus of the ICP promotion program is on investment by foreign firms in labor intensive production for export, the substantive employment generation potential of domestic based, small scale enterprises is not being overlooked. A number of governmental and private

sector programs are assisting small entrepreneurs with mixed but encouraging results. While the GOP's programs are evidence of its favorable policy toward small enterprise, that is about as far as the policy goes. The existing programs collectively lack clear direction, definition and coordination.

USAID is orchestrating and has enlisted GOP and private sector support for a structured dialogue over the next several months which will culminate in recommendations by a ministerial level policy council on the most appropriate roles for the several institutions involved, the policies they should follow, and the initiation or expansion of services to small entrepreneurs in areas where these are found to be inadequate. Among the results expected from the dialogue are a movement toward more realistic rates of interest on loans for small scale enterprises, expansion of lending by commercial banks, and the use of voluntary services, interest spreads and user fees to provide training and technical assistance. A major project to provide technical and financial support for small scale enterprise is planned for FY 1984.

(e) Private Sector Organizations

The Mission strategy is aimed at securing conditions under which investment and other private sector decisions may be facilitated and at increasing the competence of that sector to respond to investment opportunities. The elements which comprise this strategy are (1) encouragement of appropriate governmental attitudes and concomitant policies , (2) encouragement of private sector self-examination to bring about the

realization that self-interest and public purposes can be mutually supporting, (3) development of private sector organizations as appropriate and responsible opinion moulders and as resource mobilizers.

Panama has a large number of active and vocal organizations representing private enterprise. Some are broad-based, such as the Panamanian Chamber of Commerce, the National Council of Private Enterprise (CONEP), and the civic organizations (e.g., Rotary Club). Others represent segments of the private sector such as the Society of Panamanian Industrialists (SIP), the Association of Panamanian Business Executives (APEDE), the American Chamber of Commerce of Panama, and associations of small business people. These groups are important to our strategy because they are the voices of private enterprise in the policy dialogue, influencing public opinion and government policy. They are capable of organizing and carrying out action programs as well as supporting them financially.

Many of these organizations were revitalized during the 1971-74 period of strained government/private sector relations to voice opposition to government policies and programs. They thus have a tendency to view government decisions and actions as hostile and to see them from the narrow perspective of their own members' interest, ignoring the greater public good. With the change in government/private sector relations, it is important that these organizations begin to engage in some constructive activities in addition to serving as critics.

USAID helped sponsor a 1982 seminar which brought together a cross section of Panamanian businessmen with representatives of the

Government, military, church, and labor unions to discuss their roles in the country's development. They looked at Panama in the light of the upheaval taking place in other Central American countries and reached a surprising degree of agreement on the necessity of closer cooperation among the groups represented and a new and more socially sensitive role for private enterprise. We will support the continuation of such broad activities.

In addition, we will work with and through the various private sector groups to increase their responsible participation in public policy making and direct action programs which contribute to Panama's economic and social development. Examples of the latter are funds and foundations established to provide scholarships, a survey undertaken by the American Chamber of Commerce for the Investment Council, and the training program for small entrepreneurs carried out by APEDE with an AID grant.

The most widely shared and strongly felt concern of the private enterprise groups is for development of Panama's human resources through expanded opportunities for training and education. This concern takes different forms, from encouraging scholarship in the public schools to skills training and broadening the base of technical and managerial talent to support the expansion of productive enterprise and employment. A common thread is the feeling that far too many young Panamanians are going to Russia and Eastern Europe for their college education because scholarships are readily available and they do not have the means to go elsewhere. When they return, their attitudes and abilities are often unsuited to productive employment, they may find positions in the government, but they are seen as a liability to the

country's political and economic development.

There is presently underway among the private sector groups a universal, if not necessarily concerted, effort to launch a program which will address their training and educational concerns on a scale that will produce substantial results. USAID will follow their efforts, which include fund raising in Panama and the seeking of private sector support in the U.S., with a view to the possibility of providing technical and financial assistance. If they are able to organize effectively and raise sufficient funds, AID support in the form of a matching grant of as much as \$3 million in Economic Support Funds would be appropriate. Depending upon their success in organizing and fundraising, our response could be a more modest OPG.

(2) Agriculture

The goal of our agricultural program is to assist the Government and the private sector to increase output and employment opportunities in the agricultural sector while conserving the natural resource base.

There must be a fundamental change in perceptions of Panamanian leadership if the agriculture sector is to grow and make a more important contribution to the economic development of the country. Those setting policy in the past have essentially seen the sector as a means to solving social and political problems. Large numbers of unemployed landless laborers were settled in asentamientos in order to provide them with social services and increase farm production. State enterprises were organized to produce some of the major export crops. Price regulation was used to direct private sector efforts. But these experiments have not been successful. The costs of these

policies have been high and one of the priorities of the De la Espriella Government is to reduce them. The AID strategy is to help change perceptions and policies and to help promote a commercially efficient agriculture responsive to market forces. More specifically, the AID strategy will focus on promoting non-traditional and other products which Panama can grow economically and on expanding the agro-industrial base of the country.

In order to help Panama reach the above goal, the Mission will focus on (a) strengthening the capacity of the GOP to analyze and formulate agricultural policies that promote greater productivity and job creation; (b) improving the Government's capacity to develop new production and processing technologies and disseminate them widely to producers; (c) strengthening private agricultural marketing, processing and transportation services; and (d) strengthening both the Government and private sector's capacity to protect and conserve the resource base of the country.

(a) Policy Formulation

AID continues this effort along the lines established in our FY84 CDSS; i.e. developing the capacity of the Ministry of Agriculture to analyze major problems and devise policies and programs that lead to increased productivity and job creation. After an initial false start, key staff changes have been made in the Ministry's Office of Planning and we are proceeding to bring in initial technical assistance. We plan to continue with substantial non-project technical assistance under PD&S until we are more sure what the approach will be and the likely results. If successful, we will

proceed with a major four-year planning project commencing in FY84 to provide technical assistance, training and limited equipment support to (1) build the Ministry's planning capability and (2) institutionalize a process of dynamic policy analysis and formulation.

(b) Technology Development and Dissemination

Our activities in this critical area are to be continued and expanded. The IDIAP Loan (525-T-050) is underway to help build the National Research Institute's basic physical facilities and to initiate on-farm research programs for key crops and enterprises in eight pilot priority areas of the country. Research is being conducted with preliminary results already available. Long-term technical assistance from a U. S. university has begun. However, the present areas of IDIAP's concentration are but a fraction of Panama's farming area; an expanded research program for other areas of the country and focusing of research on products with significant economic potential are called for and planned during the CDSS period. In FY 1982 a new extension project was initiated in Chiriqui Province with a \$7.5 million AID loan/grant. If this experience is successful it will be duplicated in other areas of the country.

Finally, to support IDIAP's research efforts and to strengthen the new extension effort, an upgrading of middle-level agricultural training is needed. Not only must the number of new technical level graduates be increased, but the quality of their education must be improved if Panama's agricultural sector is to become revitalized. We have initiated a review of

technical mid-level agricultural training to determine demand and appropriate institutional mechanisms to fill that demand. Depending on the outcome of this review, we would consider a possible loan project in FY 86.

(c) Food Processing and Agro-Industry

Two of the major constraints to a modern commercial agricultural sector are marketing and processing. With the completion of storage facilities under AID's 1975 \$6.0 million marketing loan, basic grain marketing should significantly improve. However, marketing channels for non-traditional commodities including fruits and vegetables are woefully inadequate. Also, there are few linkages to potential markets outside of Panama for non-traditional commodities. The potential in this area is exemplified by one major transnational firm working with industrial tomatoes in the central provinces. In just a little over a decade this company built a major processing and canning business employing thousands of farmers and laborers in tomato production and in two major canning plants. A similar effort by a multinational enterprise in shrimp farming is beginning to pay off. There are other such opportunities in fruits and vegetables. The Government is anxious for the private sector to replicate these experiences with other commodities; however, the effort is constrained by a lack of capital and basic information on post-harvest technology, storing, processing, and canning, as well as by sector policies.

At this juncture, the Mission is negotiating a cooperative marketing project which will not only strengthen the private sector

cooperative movement but will also improve marketing channels through new processing, packing and transporting facilities for non-traditional crops. At the same time the Mission has opened a dialogue with a powerful private sector group, United Producers of Chiriqui, for the purpose of exploring possible financing for new agri-business operations for non-traditional crops and enterprises. Successful experiments have already been initiated by this group in the export of plantain to the U.S. Another group is successfully exporting melons and plans a significant expansion of this operation. We see still other opportunities with appropriate capital, entrepreneurial activity and development work. We plan to initiate a review in FY 84 to determine the potential and needs for expanding the agro-industrial sub-sector.

(d) Natural Resources

Panama's land resources suitable for agriculture and intensive cattle raising are relatively limited. Destructive agricultural practices, deforestation and consequent extensive soil erosion are rapidly depleting this limited resource base.

We have begun to develop an institution, RENARE, in the Ministry of Agriculture through a 1979 AID loan for \$10 million to conserve the Canal watershed and two smaller watersheds. The challenge is now to expand the activities of this organization to concern itself with natural resource management and development to secure the country's agricultural resource base. We see significant opportunities to promote new drainage, soil erosion control and fertilization practices through the new FY 82 extension

project. Additional efforts in support of natural resources conservation in Panama will be considered during the CDSS planning period.

(3) Urban Development

The Mission's urban development strategy concentrates resources on the production of shelter solutions, including new and upgraded units, based upon sound technical and financial practices, continued institutional development and coordination and proper urban planning. The strategy supports participation of private sector institutions to broaden their involvement in below-median income housing in the Panama Metropolitan area and in secondary cities. The goal and basic thrust of our program remains the same as described in our FY 84 CDSS.

(a) Policy Formulation

Policy development and planning have been closely related to the housing projects AID is funding, i.e., urban renewal in Panama City, the secondary cities program, and San Miguelito squatter upgrading. Over the CDSS period we will expand our policy dialogue for the purpose of affecting not only the shelter delivery system for low income families but also the overall shelter development framework.

We are starting a review of national housing policies to identify those legal and financial factors that prevent greater mobilization of domestic resources for housing, including participation by the private sector in providing housing for income groups that fall below or near the

median-income level. Another focus is the strengthening of the key public sector housing finance institution, the National Mortgage Bank (BHN). The feasibility of a financial system in which mortgage insurance and discounting of mortgage instruments can help increase the flow of resources to the sector will be examined. The role of the Social Security System and of other institutions in providing resources to strengthen shelter finance will be reviewed. The review of national housing policy will be a key issue of the second \$25.0 million tranche of the \$75.0 million HG commitment agreed to as part of the Canal Treaties.

In addition, AID will support GOP efforts to address problems related to controlling urban sprawl in Panama and Colon, including more efficient use of public investments in urban infrastructure and services, the utilization of appropriate environmentally-sound approaches to the development of new housing areas, and improved coordination among the public entities that shape the urban environment. At this point we believe that rather than physical plans, a coordination process is needed involving mutual agreement on objectives by the urban development-related agencies in implementing the physical plans that have been developed for the Metropolitan area and secondary cities. The effort will build upon the coordination mechanisms created in the integrated development program for San Miguelito funded with HG resources in the late 70s.

To define and make effective a coordinated urban development process we estimate a need for \$200,000 in development assistance grants, complemented by central funding, each year starting in FY 85.

(b) Shelter Production

After an initial delay, the first \$25.0 million tranche of the HG program is well underway. Both the Ministry of Housing (MIVI) and the National Mortgage Bank (BHN) are making substantial strides in improving their respective capacities to produce low-cost shelters and to manage the sector's financial resources they control. With regard to MIVI, successful efforts are being carried out to complete projects consisting of new progressive, low-income housing solutions appropriate for the needs of the metropolitan area and secondary cities. Urban renewal and home improvement components of the MIVI housing program are being initiated and will continue to be supported. The capacity of MIVI to plan, design, execute and manage urban renewal activities will be supported by the program and through technical assistance.

Particular emphasis is being placed on developing designs that fit the paying capacities of inner city residents and a programming strategy to minimize displacement of inner city families. Home improvement activities are being supported particularly in expanding the program nation-wide and in developing more efficient implementation procedures. New low cost shelter solution prototypes being promoted by MIVI in secondary cities and Metropolitan Panama will be refined. Finally, experiments in developing "reception areas" for migrants to secondary cities and from rural centers to Panama will be examined more vigorously as a new approach to meeting urban housing needs of the poor.

USAID will be developing a second \$25.0 million follow-on HG program for FY 83 approval. Shelter projects to be financed will be based upon the rational selection of sites so that they are consistent with existing and planned infrastructure and growth plans for municipalities where projects are to be located. Urban renewal efforts will be continued to improve inner city housing conditions and, at the same time, to make better use of public investments that already have been made. New minimum shelter projects and reception areas for immigrants should be located in areas abutting or in reverted territories of the former Canal Zone where public investments have been or are planned to be made. Housing development will be executed in the context of physical plans and investment activities of the GOP and will take into consideration the long-term consolidation of the metropolitan area and Canal corridor. Outside of Panama, development will be coordinated with municipal growth plans initiated under the URBE program.

(4) Other Activities

(a) Health, Education and Energy - USAID's health activity ended in 1982; the only remaining education project is ending in FY 1983, and the Alternate Energy Sources project will be concluded in FY 1984.

(b) Population - Through the Mission's health and population programs we have assisted Panama in greatly expanding the availability of family planning services and substantially reducing its rate of natural population growth. The present Population II project provides contraceptives and emphasizes measures to increase the acceptance of family planning among

the younger and rural segments of the population. It is now under evaluation and will be revised as necessary to make the most effective use of the remaining funds. This will involve assessment of Panama's ability to sustain present activities when our assistance ends and strengthening of that ability where necessary. Because of GOP budgetary and administrative limitations more reliance will be placed on the private sector, and the revisions will probably require extending the project for an additional year, through FY 1985.

(c) Nutrition - Following AID/W guidance, PL 480 Title II support of school and maternal child health feeding programs is being phased out, with the GOP gradually increasing its support and assuming full responsibility for their continuation in 1987. The success of planned phase-over is dependent upon retaining the services of CARE as the responsible PVO through the phase-over period.

While less evident here than in some other countries of the region, malnutrition remains a serious problem for Panama. Surveys and data on nutrition and food consumption indicate that about a third of Panamanian families do not meet 80% of their caloric requirements, and there is no evidence of improvement in this regard. The effects of malnutrition are mitigated by the widespread availability of safe water and health services which prevent it from contributing to a higher mortality rate. A just completed nutritional study shows a strong correlation between rural malnutrition and lower "off-farm" income of families and supports the conclusion that part of the answer to the problem is reducing levels of underemployment and unemployment. Because these levels are likely to rise

further before they begin declining, the incidence of malnutrition can be expected to increase unless other measures are taken to offset the effect of deficient family incomes.

The Panamanian government and private organizations are fully aware of the nutrition problem and are seeking means to alleviate it. The Ministry of Planning is much concerned with the consumption effects of governmental policies and will make use of studies funded by USAID to press for more equitable treatment of food producers and consumers. INCAP (the Nutritional Institute of Central America and Panama) has been requested to conduct a study of the feasibility of producing low cost foods through the low extrusion cooking process. USAID relies on the ROCAP Nutrition Advisor to provide technical assistance to the GOP and will continue to welcome assistance that is available from the S & T Bureau's Nutrition Office, such as the centrally funded breast feeding program that is about to be initiated. We hope also to rely on CARE for operational assistance to the GOP in carrying out programs for the malnourished. USAID's principal contribution to improving nutrition will be through our agriculture and employment activities and in the policy dialogue. Policies and programs which effectively promote more economical food production and increased employment opportunities provide the only real solution of the problem.

6. POLICY DIALOGUE IN PANAMA

The policy dialogue in Panama reflects the AID program goal to assist the Government to rethink and reorient its development strategy to accelerate

growth and job creation. It encourages an expanded role for the private sector based on the demonstrated failures of the public sector in both its direction of the productive sectors and in the operations it has undertaken in those sectors.

The approach to policy dialogue in Panama is substantially different from that found in larger AID programs involving substantial resource transfer. In Panama the approach is evolutionary and involves intensive interaction and consensus building. There are three basic steps involved: (i) determining the status of the basic policy debate underway; (ii) making available technical resources to determine facts, conduct analysis and develop alternatives; and (iii) identifying groups and key individuals whose views are compatible with our own views of the future development of Panama, supporting them particularly with the technical resources, and establishing linkages between them. The role of AID is to shape, support and reinforce the process. There is a policy dialogue underway in all three thrusts of the USAID strategy: employment, agriculture and urban development.

A. Employment

The objective of the USAID policy dialogue in the employment area is to encourage and support Panama to move to export-led growth as a key answer to growing unemployment. Several important events have taken place since the FY 84 CDSS was written. A new pro-private sector President has come into office who believes that such strategy is important for Panama's future.

Early on he made two fundamental decisions of vital importance. The most important was the creation of an Investment Council of Panama (ICP) to promote new investment and the other was the negotiation and signature of a Bilateral Investment Treaty with the U.S. Both of these actions had been strongly recommended by the Embassy and AID for the last year.

The policy dialogue in the employment area will now center on the resolution of the policy issues to make these decisions operative. These include: investment incentives, price controls, port and transport policies, labor policies and manpower planning and development. While there are changes needed in all these areas there are two sets of policies which stand out above all others--price regulation and labor policy. The Government regulates prices on a relatively large number of items in order to keep the cost of living down, ensure adequate supplies, and control quality primarily to protect low income groups of society. The Panamanian market is inherently small and does lend itself to dominance by one or two producers or importers. On the other hand government's price regulation is distorting the price system resulting in misallocation of resources, discouraging investment, and focusing producers on influencing public pricing decisions rather than on production of quality products at lowest possible costs.

Labor policy is a significant negative factor in private investment decisions. The present code was established to correct abuses of workers by management. In doing this, however, it makes it very difficult to adjust employment levels because of severance payment requirements, discourages

productivity incentives, and discourages piece work operations (used by assembly industry) and the development of apprenticeship programs. In addition, in the past, administration of the labor code has been biased against management.

USAID has been identifying and is currently working with the key public agencies and private sector groups to impact on the policy framework. The main public agencies are the Ministries of Commerce and of Labor, as well as the ICP. The Ministry of Planning should be playing a more active role. A key instrument is the AID-financed Policy Analysis and Research System (PARS), a policy analysis unit in the Ministry of Commerce supported by an interagency commission. The new Investment Council is vitally interested in each of the above issues. An AID advisor is encouraging an active role by both the board of directors and the staff in identifying the policy issues which impact on investment and using the PARS to define the ICP's position.

Through the Workforce Development Project we are discussing with the Ministry of Labor the need to modify the provisions of the labor code dealing particularly with issues of productivity. We recently asked both the head of the ICP and of CONEP (the private sector umbrella organization) to support the need to have a private sector majority in the board of directors for the new National Training Institute (INAFORP). The objective of this effort is to establish the linkages among a core of key public agencies and private groups so that they understand the problems impeding the export drive and develop the necessary consensus for resolving them.

In the private sector, Panama has a large number of local organizations, APEDE (Business Executives), SIP (Manufacturers Association), CONEP (private sector umbrella group), American Chamber of Commerce, Panama Chamber of Commerce, etc. They have proven to be a potent force in supporting or impeding policy changes. Over the last year we have established relations with the major ones and are getting to know and understand how and why they operate. We are now beginning to work with them in defining issues and establishing linkages to the public agencies. For example, The American Chamber is conducting an investment survey for the ICP and SIP is helping the USAID and the Ministry of Labor shape our Workforce Development Project. APEDE is deeply involved in small business training and working with the small business programs both in the Ministry of Commerce and the National Bank of Panama. The objective is to involve these organizations in the process and help them clarify the issues and take positions which take into account the public interest as well as their individual interests.

There is a major policy dialogue underway in the small business subsector. In order to address a series of conflicting policies, duplicate programs, differing interest rates, etc., USAID has been promoting subsector conferences which pull the various actors in the sector together and encouraging the Minister of Commerce to give direction to the subsector. APEDE held one seminar on the subject and a second is being developed by the Ministry of Commerce.

Under the policy dialogue emphasis, and as discussed in Section 4 of this document, we are proposing to help address the lack of an overall

GOP strategy for accelerating growth and addressing the growing employment problem. USAID has initiated contact with the Ministries of Planning and the Presidency on the desirability of establishing a strong planning capacity in MIPPE to analyze and develop strategic and policy alternatives at the national and sectorial levels. If successful, we will expand these talks into a major technical assistance effort to help the government develop a program for the new government due to take office in 1984.

B. Agriculture

The policy dialogue in the agricultural sector is underway but the process has been much more difficult and slower. As noted previously, there is a growing realization that government policies in effect over the last decade have not yielded adequate results. These range from an overdependence on state farms and state enterprises to produce basic foodstuffs and export crops to a lack of coherent policies in almost every area of production, marketing, prices and land use. Even more important there is a deep-seated split in the sector between those who see agriculture as a social problem and those who see possibilities for modern, efficient agriculture. Some officials in the Ministry of Agriculture and throughout the government, as well as key figures in the private sector, have realized the need for change from past socially oriented policies to an economic orientation, making the agriculture sector more self-sufficient. The solutions are not yet clear, but there is an active public debate seeking solutions and trying to initiate policy changes.

AID's main objective in the dialogue has been to get the government

and private sector to make a serious effort at determining where agriculture is going and the policies required to move it. We are advocating the establishment of a major analytical unit in the Government to examine, in detail, key agricultural policy issues. We would specifically support change from a focus on state-directed socially-oriented policies to those which promote a market-oriented commercial agriculture. Central to this process is convincing the Government to move away from directing the sector through price regulation. We have made this the focus of our dialogue at the moment. At the same time we have begun to identify and open up contacts with private sector groups and other institutions (e.g., University of Panama) to work with them on clarifying the issues and developing possible solutions.

A USAID effort to begin policy studies in the Ministry of Agriculture was sidetracked by a combination of bureaucratic foot-dragging and two successive changes of Agriculture ministers. Using the government's incoherent price policies as a basis, the dialogue was broadened to include the Ministry of Planning. The current Minister of Agriculture has now decided that a planning effort is needed and has already initiated a preliminary study of prices for key commodities. We have worked with him informally in developing new price policies in rice and meat. The previous director and deputy of the agriculture ministry's planning office have been removed and a request for assistance has been received. At the same time the Ministry of Planning is to conduct price studies. Several key figures outside of the government have made inquiries on participating in such a study effort. Because of our disappointment with the previous planning attempt we first will

respond with substantial non-project technical assistance initially to see if an appropriate policy group can be set up and then follow-up with project funding.

The overall effort to move the Ministry into commercially oriented agriculture was reinforced by two recently developed AID projects. The development and approval of the agricultural extension project required a major effort both because of opposition within and outside the Ministry to an extension service for small and medium independent farmers, which was seen as the first step away from the Ministry's traditional focus on asentamientos. The focus of the project on production services for commercial farmers in an area of high agricultural potential instead of a focus on meeting social needs in an area of low agricultural potential was also the cause of sharp debate. The debate reached into the Ministries of Planning and Finance, as well as Agriculture.

The Mission is in the process of negotiating a cooperative marketing project which is attempting to strengthen the cooperative movement. This again is promoting an alternative to asentamientos. A requirement for substantial government support in a period of austerity is forcing the Government to consider carefully the priority of the cooperative movement. The project will also support the private sector moving into vegetable and fruit marketing channels as an alternate to a very inefficient public marketing agency.

C. Urban Development

The policy dialogue in the urban development area has been with the public sector involving the Ministries of Housing, Planning and Finance, and has focused on getting the Ministry of Housing to make the decisions, establish policies and set up procedures to carry out the \$25.0 million first tranche of the Canal Treaties' related HG program. The policy dialogue resulted in key decisions governing the urban renewal and secondary cities programs. The Ministry of Housing, under considerable political pressure, was inclined to produce and turn over as many units as possible with minimum thought to client needs, desires or income, to fitting the units into the surrounding community, or to the financial requirements on the national treasury. AID's insistence and marshalling of support from other Ministries led to the needed reversals of policy by the MIVI. Among the most important policy changes achieved were: (i) housing solutions tailored to the income of beneficiaries, (ii) a reorganization of the Ministry that established the practice of starting project development with surveys of the socio-economic characteristics of the potential clients upon which design work is to be based, (iii) an innovative variable mortgage repayment scheme to permit a larger number of lower income residents to participate in the program and (iv) the acceptance of home improvement loans and sites and services areas outside of Panama City instead of the traditional housing development approach.

In addition, we are making progress in clearing up the financial condition of the Mortgage Bank (BHN), finally getting action on a number of

financial improvements. The Bank, however, is still not playing the dynamic role we would like to see.

We now propose to expand the dialogue on shelter policy and urbanization. It will pursue two clear and urgent needs: a national housing policy that addresses all income groups and a workable planning process that integrates the reverted areas from the former Canal Zone while making the most effective use of public investment. While the upper middle and high income segments of the shelter market are being served adequately, the lower and lower middle income market segment is not. This is a market that is growing rapidly as Panama develops and as new entrants seek admission into the rapidly expanding middle class through home ownership. This market could be served well by the private sector if the policy framework were adequate and the financial mechanisms existed. Mobilization of domestic resources, an appropriate set of roles for public and private institutions, and the establishment of necessary financial mechanisms are the issues that USAID will be looking at in the development of a second tranche of the \$75 million HG program.

Another area to be addressed is urban planning. Panama is a rapidly growing and sprawling city which has attracted substantial public investments in infrastructure, some of which are not being fully utilized. The Canal Treaties are making available new development areas that could result in the inducement of even more sprawl than currently exists. What appears to be lacking is not a physical plan as such but the establishment of a process of coordination among public institutions which invest in and manage urban

infrastructure and services. The focus of the dialogue will be on attempting to develop that process. This will also be done utilizing the development of the second tranche of \$25.0 million HG as a tool.

7. PRIVATE SECTOR

A. Relations with the Government

The improvement in relations between the Panamanian government and the private sector described in the FY 1984 CDSS has advanced significantly in the past year, following the change of government. President De la Espriella is a former banker, has close friends among businessmen, and is considered an able economic and financial administrator. He has brought into the government a large number of businessmen, including members of opposition political parties. Both the President and the head of the National Guard have spoken publicly of the need to change the housing law, price policies and the labor code. Shortly after the President took office the planned divestiture of a number of state enterprises was announced, the Investment Council was created, and the Bilateral Investment Treaty with the U.S. signed. Taken together these developments represent a major shift by the government toward positions that have long been held by the private sector and a clear recognition of the leading role that the private sector must play in the country's economic development.

While relations with the present administration have reached a high point, the private sector retains its deep seated suspicion of government per se. Businessmen are still reluctant to support actively initiatives of the

government, though they seek government support for their own. They know that the political winds can shift and fear that the government may turn against them again if the Guard and the governing party find it expedient. This underlying hostility of the private sector toward government is persistent, and will not likely diminish until the democratic process is firmly established in Panama and a new generation of business leaders is willing to accept its reasonable share of political power.

The extent to which the private sector will be used as a tool for development, by the GOP and by AID, depends on the political process. If the present, private sector oriented government is replaced, before or after the coming election, by one which adheres more strongly to the revolutionary precepts of the Torrijos period, our strategy will be harder to pursue. Nevertheless, economic necessity will not permit any government to long ignore the private sector as a development tool.

B. Employment

As is clear from various other sections of this CDSS Update, the primary focus of USAID's participation in the policy dialogue and of our assistance under this goal is on the use of the private sector to create jobs. We will pursue this through assistance to planning and policy making functions of the government as well as its operational programs which affect the private sector. We will encourage and assist programs which bring government and the private sector together to achieve common objectives. And, given their historic suspicions and often conservative nature we will assist

private organizations directly in activities that involve them constructively in the development issues facing Panama, e.g., small business, manpower training, scholarships, etc.

C. Agriculture

Our agricultural strategy hinges on the expansion of commercial production and agro-industry as profitable private enterprises. This expansion will depend to an important degree on policy changes moving toward a free market in agricultural products. Helping to bring about these changes is our highest priority in the sector. Our assistance to public institutions in the sector will emphasize those activities that contribute most directly to the productivity of private enterprise, such as research and technology transfer. We will involve private U.S. organizations with Panamanian counterparts and assist in establishing mechanisms and credit facilities to stimulate new agricultural production and processing enterprises.

D. Urban Development

Our urban strategy will work toward the development of policies which maximize the use of private sector financial resources for real estate development and housing construction. Construction of low-cost housing and site preparation under the housing guaranty program are performed largely through contracts with private firms, and these projects stimulate employment by associated industries producing building materials, home furnishings, etc. The housing guaranty program itself provides Panama with an excellent example

of how an incentive provided by government can generate private investment in support of developmental objectives.

8. OTHER DONORS

The IMF's role in Panama has been one of a financial advisor helping the Government establish a sound financial program to support a stable economic growth pattern. Its purpose has not been to save Panama from the brink of economic disaster with large transfusions of monetary resources. Instead, over the last ten years or so, its approval of the Government's yearly programs has provided the commercial banks with the assurance they have needed to continue financing Government deficits in the \$200 to \$400 million range year after year. Whereas the IMF's program approval might not have been an explicit requirement before banks would consider lending to the Government in past years, with the international liquidity crisis, a huge Latin American commercial debt problem, and a Panamanian public debt that has risen once again to 90% of GDP, it appears that the IMF's approval of the Government program will be a prerequisite to further commercial loans. This gives the IMF significant leverage when it discusses the corrective measures it believes the Government should undertake in order to bring financial stability to the country's operations.

While the IMF's principal concern is the establishment of a program which will lead to fiscal stability in the fairly short-run, it has not confined itself just to recommending budget cutting and revenue programs that directly reduce the deficit. Instead, it has used its "fiscal stability" leverage to

influence the country's overall policy framework in an attempt to produce an economic fabric which will support long-run financial stability. This has become particularly true since 1979. At that time the Government requested the IMF's help in establishing a financial plan which over a few years would reduce the Government's inordinately large public debt to acceptable levels while allowing fairly steady economic growth to continue. As would be expected, the IMF has suggested, and the Government has adopted, various budget cutting and revenue measures in order to reduce the dependence on loans to finance its budget. And, in support of long-run stability, the IMF has continuously suggested numerous policy changes which would, in its opinion, stimulate productive investment, and employment generation, and in the end provide the revenues needed to finance the Government's operations, while reducing its size by eliminating many subsidies and state enterprises that year after year have been draining its coffers. For example, the IMF has been pressuring the Government to adopt greater flexibility in pricing policies, particularly for agricultural products. It also has been urging that pricing policy changes not be considered in a vacuum, but rather, in conjunction with other policies affecting investment decisions such as those related to tax incentives, effective protection (tariffs vs. quotas), and labor relations (labor code).

In most countries devaluations are used to change a country's prices relative to the rest of the world in order to make its exports more competitive and its imports more expensive. Since that is impossible in Panama, it is necessary to eliminate those internal policies which are

preventing the most efficient use of resources, thereby producing absolute prices which are higher than a more rational group of policies would otherwise create, and which place the country at a disadvantage vis a vis the rest of the world.

The IBRD is a major lender, with a pipeline of approximately \$200 million, largely in the fields of energy, ports, roads, and in the Colon development program. The Bank has been playing a limited role in the macro policy debate until recently. Primarily it has worked with the IMF in trying to shape the investment budget, giving priority to energy, and in encouraging major changes in tariff policy as part of an initiative to get the Government to shift from import substitution toward an export strategy. It appears that the IBRD will significantly expand its role in the policy area. The Bank is considering a major structural adjustment loan to help the country over this year's budget crunch and will use these negotiations to encourage important policy changes. Policies in at least three areas are being examined: agricultural pricing, quotas and tariffs, and the management of state enterprises.

The IDB is the other principal provider of development assistance to Panama with a portfolio of some \$300 million in energy, roads, ports and agriculture. Though a program of this size offers the opportunity for exercising leverage on policy issues, this potential is not being realized. The IDB is a bank that serves its clients, who also form a majority of its board of directors. Its country representatives are expected to keep up cordial relations with the government, maintain or expand their loan portfolios and keep their projects moving. As development professionals they

will give their verbal support to the other donors on broad policy issues, but their leverage is used sparingly, even for purposes of their own projects. USAID can maintain good relations with the IDB staff in Panama, exchange information, and try to avoid program conflicts, but we cannot expect them to throw the weight of the Bank behind our concern with policy reform.

The IMF and IBRD are the prime movers of policy reform in Panama. In its present fiscal situation the government must bend to their combined influence in order to obtain the budgetary resources to avoid a more drastic curtailment of its operations. This enables the government to begin making difficult policy changes with a degree of political impunity. While it may diminish, the fiscal problem will not go away in a few years, giving continuity to the process of policy change. Even if a less responsible government were to take power, it would be constrained to continue the process, because Panama cannot resort to monetary policy.

It is the climate created by the IMF and IBRD that makes possible a more effective USAID role in the policy dialogue. We have the advantage of being on the scene and in touch all of the time, permitting us to stimulate discussion and analysis of policy alternatives. By helping the Government predict the effects of different policies and the steps necessary to carry them out over time we can facilitate the process of reform in response to the international agencies.

The World Bank, IMF and AID are moving together in Panama. Our programs are mutually reinforcing, and we communicate when they have teams in the country. The Bank is especially forthcoming, agreeing closely with us on the

kinds of policies that should be pursued, and raising the possibility of joint projects in the future. We realize that without a formal consultative group, which is not called for in Panama, the international agencies must limit the information they share and restrict their contacts with AID to some degree. Our mode of coordination is through personal contacts at the professional level whenever we have the opportunity for these. This can be effective without impinging on the relationships of the other agencies with the Government of Panama. However, its effectiveness is truly limited by the fact that we cannot talk with them except when they are here in Panama. Our communication and coordination could be substantially improved if similar contacts could be established and maintained by AID in Washington with regular reports to USAID.

9. ASSISTANCE LEVELS

A. Resources

The annual levels of \$19.0 to \$20.0 million proposed in the FY 84 CDSS and the rationale for these levels remain valid. These levels are generally consistent with the approved planning levels of \$16-19 million but higher than the FY 84 Congressional level of \$13.0 million. We believe that an annual level in the \$15.0 to \$20.0 million range is necessary if the policy formulation orientation of our strategy is to be maintained. AID has to be seen as a credible donor if access and contact are to be maintained throughout the Government, including the non-line Ministries of Planning, Treasury, Presidency and the National Bank. In fact we have been fortunate enough to

maintain good access based on our pipeline, project development work, and astute use of incremental funding. There is a limit to this, however. In addition it is through the process of developing, negotiating and implementing projects that we are able to claim the attention of Panamanians and stimulate discussions of policy issues. We cannot be effective at the policy level by simply advising the Government that we wish to study and provide advice on their policies. The program context is essential. This policy orientation can be maintained in Panama at the \$15-20 million range if the AID effort is seen as first, a U.S. Government effort which involves a larger impact than just AID and secondly, if the quality of advice which AID provides is first class and AID is seen as an innovating agency "out-in-front" on important development issues of concern to thinking Panamanians. The proposed program, at the \$19.0-20.0 million levels, follows:

PROPOSED ASSISTANCE PLANNING LEVELS
(In thousands of Dollars)

		FY 85	FY 86	FY 87	FY 88	FY 89
I. <u>Employment Generation</u>		<u>11,650</u>	<u>8,100</u>	<u>4,100</u>	<u>11,400</u>	<u>11,350</u>
A. Policy Formulation	(G)	650	650	650	650	650
B. Export Development	(G)	500	500	-	300	300
	(L)	5,000	2,000	1,000	5,000	5,000
C. Skills and Productivity Improvement	(G)	-	500	-	-	-
	(L)	2,000	1,000	-	5,000	5,000
D. Small Business Development	(G)	300	300	300	300	300
	(L)	3,000	3,000	2,000	-	-
E. Private Sector Organizations	(G)	200	150	150	150	100
	(L)	-	-	-	-	-
II. <u>Agriculture</u>		<u>8,950</u>	<u>13,200</u>	<u>15,200</u>	<u>8,950</u>	<u>7,450</u>
A. Policy Formulation	(G)	700	700	700	700	700
B. Technology Development and Dissemination	(G)	-	500	1,000	500	-
	(L)	-	4,000	8,000	3,000	3,000
C. Food Processing and Agro-Industry	(G)	750	1,000	500	250	250
	(L)	2,000	7,000	5,000	-	-
D. Natural Resources	(G)	500	-	-	500	500
	(L)	5,000	-	-	4,000	3,000
III. <u>Urban Development</u>		<u>250</u>	<u>250</u>	<u>250</u>	<u>250</u>	<u>250</u>
A. Policy Formulation	(G)	250	250	250	250	250
B. Shelter Production	(HG)	(25,000)	-	(15,000)	-	(15,000)
Total DA		<u>20,850</u>	<u>21,550</u>	<u>19,550</u>	<u>20,600</u>	<u>19,050</u>
DG		3,850	4,550	3,550	3,600	3,050
DL		17,000	17,000	16,000	17,000	16,000
PL 480 Title II		(650)	(400)	-	-	-
HG		(25,000)	-	(15,000)	-	(15,000)

B. Staffing Implications

Mission staffing is in the process of being adjusted to the strategy developed in the FY 84 CDSS. At the same time overall ceilings have been reduced. Over the previous three fiscal years the USDH were reduced from 26 to 17 including one regional contracts officer. The USDH has now leveled off at 17 and must stay at that level. Concurrently the Mission staff is being restructured. The former Human Resources Division has been changed to a division with a heavy private sector and skills training focus. Two GDO's are in the process of being replaced by two persons having private enterprise background. A Labor Department PASA is being recruited to provide the manpower planning and development technical skills and direction. A GDO with a heavy population background is being recruited to replace the population officer and maintain contacts with social services activities of the GOP. The remaining task is to strengthen the economic and program capacity of the Mission in order to be able to support the policy formulation effort in all three areas. This will be done by recruiting two IPA economists to work with the USDH economist, as well as upgrading the FSN economist position. In addition we will make greater use of project funded PASA's and contract personnel for planning and monitoring implementation. An important means that will be employed to increase efficiency of Mission staff is expanded use of computer and word processing equipment.

FSN staff will be reduced from 48 to 43 in FY 83, a continuation of the reductions of the previous three years from a level of 60. No further reductions are possible. In addition to reductions it has been necessary to

upgrade and change the composition of FSN skills. Panamanian employees are now project managers on major projects and one has been appointed chief of a division (Engineering). In addition, we have had to release several FSN's in skill areas no longer needed and begin limited recruiting of persons with different skills. The reduced ceilings require that employees be carefully matched to position requirements and that they work at near maximum efficiency if the strategy is to be successfully carried out.

USDH staffing is proposed as follows:

	<u>USDH STAFFING LEVELS</u> <u>1/</u>				
	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>
Direction and Program/Economics <u>2/</u>	4	4	4	4	4
Development Resources	3	3	3	3	3
Agriculture	3	3	3	3	3
Multisector (Private Enterprise)	3	3	3	3	3
Program Support <u>3/</u>	<u>4</u>	<u>4</u>	<u>4</u>	<u>4</u>	<u>4</u>
	17	17	17	17	17

1/ Excludes Regional Housing Office (3 USDH).

2/ Offices of the Director, and Development Planning.

3/ Executive and Controller offices, Regional Contract Officer.